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C O N F I D E N T I A L SECTION 01 OF 06 KYIV 001092

SIPDIS

DEPT FOR S/EEE - MORNINGSTAR/NESHEIWAT, EUR/UMB, EB/ESC/IEC
- GALLOGLY/WRIGHT
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E.O. 12958: DECL: 06/30/2019
TAGS: ENRG EPET ECON PINR PREL RU UP
SUBJECT: UKRAINE: SPECIAL ENVOY MORNINGSTAR DISCUSSES GAS
TRANSIT, ENERGY

Classified By: Charge James Pettit for reasons 1.4(b,d).

¶1. (C) Summary. During a June 19-20 visit to Kyiv, Special Envoy for Eurasian Energy Ambassador Richard Morningstar urged senior Ukrainian officials to begin reforms in the energy sector in order to build confidence with both European and Russian partners. In meetings with PM Tymoshenko, Energy Minister Prodan, Presidential Energy Advisor Sokolovsky, and Naftohaz, Morningstar and DOE PDAS Jonathan Elkind heard that Naftohaz is in serious financial trouble, in part because of the January 2009 gas supply and transit contracts and the company's inability to charge cost recovery rates to households. Ukrainian officials said they recognized the need for serious energy sector reforms but argued that reforms could not be undertaken until after the 2010 presidential elections. International community representatives linked any possible financing for Naftohaz to reforms in the gas sector and increased transparency at Naftohaz. The economic crisis would play a large role in the presidential elections, Morningstar was told. End summary.

Naftohaz Financing Needs for Gas Purchases

¶2. (C) Prime Minister Tymoshenko, Minister of Fuel and Energy Prodan, the Naftohaz leadership, and Presidential Advisor Sokolovsky all claimed that Ukraine needs $5 billion in financing to purchase adequate volumes of gas in 2009 and thereby avoid a potential repeat of the winter gas crisis with Russia. However, they gave various justifications of what exactly would be funded by the loan. Tymoshenko, Prodan and Naftohaz stated that Ukraine would use the loan to purchase 19 bcm of gas. However, Ukraine's gas storage facilities have a working capacity of 31 billion cubic meters (bcm). As of June 19, Naftohaz had 19.5 bcm of gas in storage, meaning that spare capacity was far less that the additional 19 bcm that both Ukrainian and Russian officials have repeatedly said was needed to prepare for winter. Naftohaz and Sokolovsky,s best estimates were that 6 to 8 bcm were needed, which was confirmed by Tymoshenko after the visit.

¶3. (C) Tymoshenko argued that Ukraine needed a four month, $4.2 billion loan from the European Bank for Reconstruction and Development (EBRD) and European Investment Bank (EIB) to meet the cost of pumping gas into storage over the summer. (Note: Morningstar later heard that the $5 billion price tag included 20 percent VAT, hence the $4.2 billion was net of VAT payments. End note). Tymoshenko stated that Naftohaz would need to make the following monthly payments to Gazprom:

July 7: $250 million
August 7: $1.3 billion
September 7: $1.5 billion
October 7: $1.0 billion
November 7: $150 million

To ensure transparency, Tymoshenko said that Ukraine would accept EU monitors inside Naftohaz to monitor gas storage facilities' levels and international auditors to monitor financial flows. Ukraine would offer the gas in storage as collateral for any financing and would only extract gas as the loan was paid back.

¶4. (C) Tymoshenko argued that the current financial crisis had worsened Naftohaz's position. Naftohaz was unable to borrow from Ukrainian banks because of their low liquidity, and international banks were also unable or unwilling to extend Naftohaz credit. Tymoshenko laid the blame on President Yushchenko for Russia's decision not to advance additional transit fees to cover the cost of gas to be pumped into storage. She said that Yushchenko had called Russian PM Putin to object to Tymoshenko's proposal. Tymoshenko said that the situation could have been logically resolved by Russia advancing transit payments, but now the situation had turned serious. The Prime Minister also said that in January she had told German Chancellor Merkel and EC President Barroso that the economic crisis could create conditions in which Ukraine would not be able to pay for gas. Tymoshenko seemed to reject a proposal that the EU had been looking into that would have European companies purchase gas and place it

in storage in Ukraine, arguing that Ukraine would not be able to then ship that gas to Europe as the gas in storage was intended to meet Ukrainian demand.

¶5. (C) Deputy Naftohaz Chairman Vadym Chuprun stated that the company had stored more gas at this point in the year than in any of the previous five years. He said he understood the concerns of other European countries, particularly those without storage facilities, because of last winter's gas cutoff. However, Chuprun argued that other European countries' concerns were not solely Ukraine's problem. He asked why Ukraine, and not the producer (Russia) or the consumer (Europe), should pay to pump gas into storage. Chuprun argued that the gas price Naftohaz paid to Gazprom and the price it received for transit services were highly imbalanced. He also noted that Naftohaz has transited 20 bcm less than average to Europe this year. Due in part to low European purchases, the revenues of Ukrtransgaz, the gas transit system (GTS) operator, had dropped, and the GTS worked at 30-50 percent of its normal load. Chuprun said he could point out several such factors currently shaping Naftohaz's finances and argued that the situation was not Naftohaz's fault.

¶6. (C) Minister of Energy Prodan said that Ukraine needed $4.2 billion to cover the purchase of 19 bcm of gas. Prodan stressed that Ukraine's gas storage facilities needed to be full to ensure the proper operation of the transit system in the winter. Without being specific, Prodan said some legislative obstacles prevented the continued use of foreign currency reserves to finance gas payments. Prodan also noted that Ukraine would be in the same position next summer -- needing to purchase gas during the summer for storage while lacking a steady stream of revenues to pay for it -- but hoped that Naftohaz would get financing in the domestic market.

¶7. (C) Presidential Advisor Sokolovsky said that Ukraine would need only around $1.6 billion to fill its storage facilities to the needed volume of 25-26 bcm before the beginning of the heating season in mid-October. Ukraine planned to use the balance of any $5 billion loan to refill the storage facilities in the winter, as gas prices were

forecasted to fall in the fourth quarter to $190/thousand cubic meter (tcm) before rising again in the first quarter of 2010 to $240/tcm. According to Sokolovsky, Naftohaz currently collected about $150 million monthly, and in June 2009 it would collect $170 million. For June gas deliveries it would have to pay Gazprom about $290 million. Naftohaz could cover the June payment, but not thereafter due to a lack of funds. In July/August, Naftohaz would need $600 million each month to pump gas into storage for the winter. Sokolovsky said that the IMF conditionality that set floors on the National Bank's foreign currency reserves would limit Ukraine's ability to continue financing gas payments through loans from the National Bank.

Donors: No Loans Without Reforms

¶8. (C) Representatives of the European Commission, World Bank, and the EBRD all agreed that any financing would need to be predicated on Ukraine undertaking needed reforms in its gas sector. EBRD country director Andriy Kuusvik confirmed that EBRD had received a GOU request for a $5 billion working capital loan for Naftohaz. He pointed out that EBRD was geared towards long-term project finance loans, and not well-situated for short-term working capital loans. He also said the $5 billion price tag was far higher than anything EBRD could absorb. Nonetheless the bank would be willing to take the lead in structuring a loan, but would expect multi-national lenders, individual countries and/or energy companies to contribute substantially. He also said the bank would need three months in the best of cases to structure such a loan, whereas the GOU claimed that it needed the money soon.

¶9. (C) Kuusvik also said that EBRD would expect clear, concrete and upfront reforms in return for its willingness to consider the loan request. This was seconded by the World Bank country director Martin Reiser. Although the World Bank

had not been approached, Reiser offered his personal opinion that the international community should demand genuine action on gas sector reforms before lending Naftohaz/Ukraine money. He said donors should require a significant tariff increase before disbursing a loan; otherwise any GOU commitment to gas sector reform would not be credible. He also suggested that donors require far more transparency into Naftohaz,s finances. If Naftohaz needed money to 1) cover the deficit caused by domestic tariffs that were lower than cost, 2) buy gas from Gazprom, and 3) service its external debt coming due this year, then donors could demand a segmentation of funding to meet each of these needs. The subsidy to cover the loss incurred by selling gas below cost could be a clear and transparent budget item which would allow anyone to see exactly how much government subsidies go to this purpose. Capital for gas purchases and debt servicing, if provided by donors in return for tariff reform, would come into Naftohaz's coffers through a direct donor loan. This would bring transparency, prevent Naftohaz from cross-subsidizing, introduce truer accountability into the company's finances, and eliminate some of the rent-seeking that currently occurred in the company.

¶10. (C) When asked by Morningstar and Elkind whether Naftohaz really needed the money, Reiser said that the GOU could continue to monetize Naftohaz's debt through central bank lending via the state-owned banks. Foreign exchange reserves, when coupled with continued IMF disbursements and IMF flexibility towards foreign reserve conditionalities, should be sufficient to meet this year,s gas bill. EC Delegation energy expert Hans Rhein noted that, in principle, Ukraine did not need 19 bcm in storage for the winter. Still, sizable reserves would be desirable if there were to be a harsh winter. He speculated that Tymoshenko needed the cash and wanted to meet the contract requirements. Ukraine and Russia had been pushing jointly in Europe for a financing

solution over the last few weeks, but likely could resolve the payment issue on their own.

¶11. (C) Morningstar stressed to all interlocutors that the United States would be willing to facilitate Ukrainian-Russian-European efforts to deal with Ukraine's short-term gas issues, but stressed that it was ultimately an issue for the three stakeholders to solve. Morningstar also underlined that the proposed financing might help Naftohaz in the short-term, but that ultimately Ukraine would need to enact real, long-term reform.

Gas Sector Reforms Needed--Timing and Severity Debated
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¶12. (C) Tymoshenko said she acknowledged that serious reforms were needed in the gas sector, but urged patience from the international community as Ukraine could not enact stringent reforms in the current economic and political climate. The gas sector would be in much better condition if Ukraine could raise domestic gas prices to cost recovery levels, she said. She also agreed that Ukraine needed to end cross-subsidizing the sector and unbundle and modernize the GTS. On gas prices, Tymoshenko pointed out that industrial consumers had paid market prices since the beginning of the year, and that household gas prices had been raised by 35 percent in the fall of 2008. Tymoshenko claimed that payment collections from households dropped from 93-95 percent before the price hike to 78-79 percent after it. Collections could drop to 50 percent, she said, if prices were raised again by 35 percent. Such stress could undermine the financial situation of Naftohaz. Tymoshenko also feared that gas price increases, coupled with the high unemployment and salary cuts that resulted from the economic crisis, could lead to social unrest. She said she wanted to raise gas prices, even double them, but that the current economic and political climate was too volatile to do so. Before gas prices could be raised, a substantial system of social protection needed to be developed. Tymoshenko said the IMF was making a 60 percent gas price increase for households a key prior action for the next $3 billion tranche of the Stand-By Agreement. If Ukraine did not raise prices, it would not get the third tranche. She asked the USG to intervene with the IMF to lessen the requirement and accept a detailed roadmap outlining sector reforms. The roadmap would be implemented

once political stability was achieved, she said, without specifying how political stability was to be measured.

¶13. (C) On the margins of his meeting with Morningstar, Sokolovsky told us that Tymoshenko was willing to increase household gas tariffs by 30 percent before the elections, but not by the 60 percent that the IMF was purportedly demanding. He also told Morningstar that the GOU would submit to the Rada during the week of June 21-26 draft gas reform legislation that would remove criminal liability for gas companies that turn off gas deliveries to delinquent household customers, remove multi-tier gas prices, and address the issue of targeted subsidies for needy households. In response to Morningstar,s question whether Yushchenko would support the laws, Sokolovsky said that Yushchenko and Tymoshenko had a "verbal agreement." Sokolovsky said that Yushchenko had been urging gas sector reform for four years, but every government has found it easier to avoid unpopular decisions, and instead negotiate with Russia agreements that turned out to be unfavorable to Ukraine. Opposition leader Viktor Yanukovych was in general open to gas reform, according to Sokolovsky, and would likely approve big tariff hikes because he could blame them on the Prime Minister.

¶14. (C) Leading Ukrainian industrialist and Yanukovych backer Viktor Pinchuk told Ambassador Morningstar that Tymoshenko would not enact difficult energy sector reforms ahead of the elections because they would lower her ratings. Even with Tymoshenko's political skills, she could not blame a 60

percent gas price increase on the IMF. Pinchuk also dismissed the possibility of establishing an independent energy regulator, as no one in Ukraine would believe it was truly independent. Ukraine's industrialists were not willing to lobby the government for energy sector reforms, he said, although they had already begun investing in energy conservation.

¶15. (C) Tymoshenko reiterated her support for the joint declaration signed by the EU, EBRD, World Bank, EIB, and Ukraine on March 23 in Brussels that seeks to link international financing for GTS modernization with gas sector reforms in Ukraine. She said that Ukraine must work to unbundle the GTS but outlined three issues that complicated that process. First, Ukrainian law prohibited changes in Naftohaz property. The law was intended to prevent Russian takeover of the pipeline. Second, Naftohaz had long term loans with European banks that allowed the banks to demand early repayment if pipeline ownership changed. Third, the contracts between Naftohaz and Gazprom could slow restructuring of Naftohaz. However, Ukraine was ready, Tymoshenko said, to develop a plan to implement the Brussels declaration. Prodan said that Ukraine was working to fulfill needed requirements in the gas sector to join the European Energy Community, but that such reforms would take time. Naftohaz's Chuprun stated that the implementation of the March 23 agreement was Ukraine's only possibility to modernize the GTS. Naftohaz had already undertaken many efforts to implement it, including starting feasibility studies on separate projects. Chuprun noted that the March 23 agreement was signed without knowledge of future Russian gas shipments, European consumption, or transit rates. Naftohaz could not develop a modernization plan without such parameters, he said. Tymoshenko said Ukraine was already implementing energy efficiency programs and other ways to reduce gas consumption. Funds from the sale of carbon credits under the Kyoto Agreement would modernize municipal heating boilers and reduce gas consumption by 50 percent, she claimed.

¶16. (C) Ambassador Morningstar said the USG could help Ukraine set up targeted subsidy programs and a roadmap for the needed reforms. Morningstar stressed that a detailed roadmap could bring confidence to European doubters. DOE PDAS Elkind noted that under Tymoshenko's leadership in the 1990s, Ukraine implemented a series of reforms in the electricity sector that eventually attracted both foreign and domestic investors. He noted that the gas sector reforms would be even more complicated, but added that the USG was looking for constructive ways to assist Ukraine's reform efforts. He urged Tymoshenko to develop a reform plan now so that efforts could begin immediately after the elections.

Deputy Prime Minister Hryhoriy Nemirya suggested that the upcoming visit of Vice President Biden could be used to bolster US-Ukrainian cooperation in the energy sector as part of the bilateral working group on energy.

January 2009 Contracts

¶17. (C) Prime Minister Tymoshenko gave a relatively positive assessment of the January 2009 gas supply and transit contracts, even claiming that the January crisis had somewhat of a "purifying effect" because intermediary Rosukrenergo was removed, and gas prices were now set by a fixed formula, eliminating the need for end-of-year negotiations. Tymoshenko noted that the quarterly price adjustments occur without any difficulty.

¶18. (C) Naftohaz's Chuprun, however, was openly critical of the contracts, arguing that both gas prices and transit fees should have moved towards market levels. He said Naftohaz had been prepared to accept Gazprom's offers of $238/tcm and $2.34/tcm/100km for transit. However, when Ukraine failed to

agree to those conditions, gas supplies were cut off, and Gazprom demanded $450/tcm. Chuprun said the contract ultimately signed on January 19 gave Ukraine a 20 percent discount on gas prices in 2009 but kept gas transit fees at their 2008 levels of $1.70/tcm/100km. Chuprun said the low fees meant that the needed investment in the GTS was two times the cost of transit operations. Separately, the World Bank's Reiser had agreed that Russia had a great deal, as Ukraine's gas prices were 10 percent higher than Germany's, whereas Ukraine was getting half of what it should for transit.

Alternative Corridors

¶19. (C) Nemyria said Ukraine wanted to diversify its natural gas supplies. Tymoshenko said that Ukraine would have sufficient capacity for Nabucco to feed into the Ukrainian GTS. Naftohaz strongly rejected Russian proposals for alternative gas pipeline corridors and noted that discussion of alternative routes bypassing Ukraine had increased since the January crisis. Chuprun rejected any notion that the Ukrainian GTS would not be needed in three to five years, calling it the only "serious stream" to Europe.

Nuclear Issues

¶20. (C) Morningstar urged Tymoshenko and Prodan to expedite implementation of contracts with Westinghouse and Holtec International for nuclear fuel supplies and Ukraine's Central Spent Nuclear Fuel Storage Facility. Timely and successful implementation of these contracts would help send a positive signal to Congress, which had allocated hundreds of millions of dollars to Ukraine's nuclear sector, said Morningstar. He also urged his interlocutors to take advantage of Holtec's offer to finance its project despite the severe financial crisis. At Morningstar,s request, Tymoshenko agreed to meet with Westinghouse and Holtec executives for a full brief on each project.

OPIC

¶21. (C) In his meeting with Tymoshenko, Ambassador Morningstar raised the ongoing efforts to solve OPIC's outstanding claim against Ukraine and urged her to complete all requirements so that Ukraine could be requalified for OPIC financing. Tymoshenko assured Morningstar that all necessary government resolutions had been passed.

Political Climate Ahead of Presidential Elections
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¶22. (C) Ambassador Morningstar met with businessman and Party of Regions MP Andriy Klyuyev to discuss the current political situation following the failed attempt to establish a broad coalition between Party of Regions and PM Tymoshenko's party, BYuT. Klyuyev said the coalition would have been "great" for

Ukraine, but it failed because Tymoshenko and Party of Regions' leader Victor Yanukovych could not overcome their "personal mistrust" of each other. Negotiations to form the coalition lasted 18 months. Klyuyev said he believed that Ukrainians were willing to trade direct election of the president for stability and growth. Separately, Viktor Pinchuk agreed that the coalition failed due to a lack of trust in the two camps. Tymoshenko, he said, was power hungry, while Yanukovych's popularity ratings were high enough to convince him that he did not need the coalition to attain higher office. Pinchuk also said that the coalition attempts were simply a means to divide power between political forces, and not an attempt to do what was right for Ukraine.

¶23. (C) Klyuyev and Pinchuk both thought that Yanukovych, Tymoshenko, and Arseniy Yatseniuk are the only real contenders in the 2010 presidential elections. Both said that the economic crisis made the outcome of the elections very difficult to predict. Klyuyev pointed to Yanukovych's 2007 premiership to assert that Yanukovych was pro-Ukrainian and not pro-Russian. According to Pinchuk, Tymoshenko had two opponents: Yanukovych and the economic crisis. Any further financial shock would hit Tymoshenko hard. Pinchuk believed that Yatseniuk would have a good chance of becoming prime minister if Yanukovych won the election. After noting that he had recently met with high-level Russian officials, Pinchuk said that the Russians would not find Yatseniuk acceptable as president. Yanukovych was the best option for Moscow, as cooperation between Russia and Ukraine would be better under a Yanukovych administration. However, Pinchuk thought that Russia would be "quiet" before the elections and "bet on both" Tymoshenko and Yanukovych.

¶24. (U) Ambassador Morningstar's staff has cleared this cable.
PETTIT